

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matter of
Simplification of the
Depreciation Prescription Process

CC Docket No. 92-296

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

GTE's COMMENTS

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its affiliated domestic
telephone operating companies

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SUMMARY

1. GTE applauds the Commission's effort to simplify the depreciation process. The FCC should act now to address the problem of governmental constraints on industry capital recovery.
2. GTE recommends Option D, the *Price Cap Carrier Option*, which stands head and shoulders above the other options. This is the only option that establishes a firm and logical linkage between Price Cap regulation and depreciation prescription.
3. If the FCC does not adopt Option D, GTE recommends Option B, the *Range of Rates Option*. After that, the next best would be Option A, the *Basic Factor Range Option*. Options B and A would at least be an improvement over the present practice.
4. GTE urges the Commission to reject Option C, the *Depreciation Schedule Option*, which would represent a step backwards.
5. GTE opposes the proposed removal of net salvage from the depreciation process.

Before the
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In the Matter of
Simplification of the
Depreciation Prescription Process

CC Docket No. 92-286
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

GTE's COMMENTS

GTE Service Corporation and its affiliated domestic telephone operations companies ("GTE") offer their comments in response to the Commission's proposal to simplify the depreciation prescription process as presented in the Notice of Proposed Rulemaking (the "*Notice*" or "*NPRM*"), 8 FCC Rcd 146 (1992).

BACKGROUND

The *Notice* (at 146) seeks comment on proposals that would "simplify procedures and reduce associated costs in [the FCC's] depreciation prescription process." Recognizing (*id.* at 147) emerging competition in the markets served by Local Exchange Carriers ("LECs" or "exchange carriers") and the FCC's "price cap regulatory plan designed to provide the incentives that occur in a competitive market," the *Notice* (*id.*) observes: "Our price cap plan encourages carrier efficiency without allowing them to pass depreciation expense changes onto ratepayers."¹ Indeed, the *Notice* (at 147 n.8) observes: "[B]ecause price cap carriers would generally not be able to pass along depreciation expense changes, higher depreciation expense can lead to lower earnings for those carriers." "Thus," adds the *Notice* (at 147-148):

[T]he scrutiny necessary under rate of return/rate base regulation may be relaxed under price cap regulation. At the same time, the telephone

¹ Footnote omitted.

industry has estimated that the annual cost of determining the depreciation rates range from \$35-\$50 million industry-wide.²

"In light of market and regulatory changes and the alleged high costs of depreciation analysis", this CC Docket No. 92-296 ("*D.92-296*") is "to determine whether [the FCC's] detailed prescription process is necessary," keeping in mind "that any streamlined procedures [the FCC] adopt[s] must be consistent with the Commission's statutory mandate to prescribe 'the percentages of depreciation' carriers may charge to operating expenses." *Notice* at 148.

Upon this foundation, the *Notice* (*id.*) proposes four options:

A. The "*Basic Factor Range Option*", which "would simplify the depreciation process by establishing ranges for the basic factors that determine the parameters used in the depreciation rate formula: the FNS³, and the projection life and survivor curve (the basic factors that determine the ARL⁴)."

B. The "*Range of Rates Option*" "would simplify the depreciation process by establishing ranges for depreciation rates."

C. The "*Depreciation Schedule Option*" would "simplify the depreciation process by establishing a depreciation schedule for each plant account."

D. The "*Price Cap Carrier Option*" would "simplify the depreciation process by allowing price cap carriers to file depreciation rates with no supporting data, but [with] continuing Commission prescription of depreciation rates."

The Commission seeks comments on these options and any other alternatives a party may wish to propose.

² Footnote omitted.

³ The "FNS" or "Future Net Salvage" is defined as "the estimated gross salvage of plant less any estimated cost of removal." *Notice* at 147.

⁴ The "ARL" or "Average Remaining Life" is defined as "an average of the future life expectancy of investment in a particular plant account." It "is composed of two basic factors: a projection life and a survivor curve." *Id.*

DISCUSSION

1. GTE applauds the FCC's initiative.

GTE applauds the Commission's initiative. Since the 1970s, GTE has been urging the FCC to simplify the prescription process. The markets served by exchange carriers are changing rapidly as such competitors as Competitive Access Providers ("CAPs") and cable television companies mount challenges. The *Notice* (at 147) recognizes that exchange carriers must be permitted to compete with new entrants.

Together with other exchange carriers, GTE has long recognized the critical problems associated with capital recovery in the face of competition and has been working closely with regulators at the state and federal level. One need only read the latest issue of any trade journal to find articles that discuss what competitors -- subject to little or no regulation -- have in store for the local exchange and intraLATA markets and how the exchange carriers are being placed under serious competitive pressure. It is apparent that portions of the existing telecommunications infrastructure are rapidly becoming obsolete.

Further, the *Notice* (*id.*) reflects the reality that, for exchange carriers under the FCC's Price Caps program⁵, there is no longer a need for detailed FCC review of depreciation.

The longer the regulatory and legislative bodies wait to address the issues facing exchange carriers, the greater becomes the risk of recovering the capital. Increased risk -- other factors being equal -- leads to more expensive capital. Then there can be a circular effect as more expensive capital makes it more difficult for exchange carriers

⁵ *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), *modified on recon.*, 6 FCC Rcd 2637 (1991), *petitions for review pending sub nom. Public Service Comm'n of the District of Columbia*, No. 91-1279 (D.C.Cir. filed June 14, 1991).

to compete. The Commission must act now to permit an effective address to the problem of governmental constraints on industry capital recovery.

2. GTE recommends Option D, the *Price Cap Carrier Option*, as by far the best of the options discussed in the *Notice*.

Simplification of the depreciation process is an important step towards the regulatory reform needed to make regulation appropriate to the new environment. These comments outline why, in GTE's view, for Price Cap carriers Option D, the *Price Cap Carrier Option*, stands head and shoulders above the other three options. Further, these comments compare the merits of Options A, B and C, placing particular stress on the unfortunate implications of Option C, the *Depreciation Schedule Option*, which in GTE's view would constitute a step backwards.

3. GTE believes that Option D, the filing of depreciation rates with minimal supporting data for price cap carriers, is the optimal alternative for revising the prescription process.

Under Option D, which would apply only to Price Cap carriers, the carrier would file its proposed depreciation rates and the FCC would issue a Public Notice seeking comment thereon. *Notice* at 148. The Commission would then prescribe depreciation rates based on the Price Cap carrier's proposals and the submitted comments.

Specifically, as outlined in the *Notice* (at 152), a Price Cap carrier would seek depreciation rate changes by filing with the FCC the following information: (1) depreciation rates in effect; (2) proposed depreciation rates; (3) changes in depreciation expense due to the proposed rates. As no supporting data would have to be furnished, the current FCC analytic process would be unnecessary. The Commission would ascertain the reasonableness of the proposed changes based on the exchange carrier's submission and any filed comments – including comments filed by state commissions; and would prescribe rates.

This plan would be consistent with the Communications Act, which does not require the FCC to choose to carry out its statutory responsibilities by means of

extensive and costly administrative procedures not justified by the results. The mechanism by which the Commission carries out its statutory assignment is within its sound discretion. For example, the three-way meeting used for many years is not a mechanism required by the Act. The Public Notice procedure that is part of Option D, together with Commission consideration of filed comments, certainly comports with the language of Subsection 220(i) requiring that the states have a "reasonable opportunity" to be heard.⁶ In the case of a Price Cap carrier filing interstate access tariffs which are not affected by depreciation expense, a simple filing of current depreciation rates, proposed rates, and the effect on depreciation expense of the new depreciation rates, together with the Public Notice, is all that is required for the Commission to issue its prescription.

The Commission's adoption of Price Cap regulation in 1990 changed not only the way exchange carriers' prices are regulated but also dramatically affected the significance of the depreciation prescription process. The Commission held that cost changes due to changes in depreciation rates are endogenous because the decision of when to deploy or retire equipment is controlled by the carrier.⁷ At the time, GTE observed that endogenous treatment would be appropriate under Price Caps "if government permitted an exchange carrier to proceed with implementing its investment decisions and appropriate charges without hindrance...."⁸ GTE urged reform of the depreciation process so it would match the theoretical model invoked by the Commission under which exchange carriers could fairly be held responsible for their

⁶ "The Commission, before prescribing..., shall notify each State commission having jurisdiction with respect to any carrier involved, and shall give reasonable opportunity to each commission to present its views, and shall receive and consider such views and recommendations." 47 USC Section 220(i).

⁷ D.87-313 Second Report and Order, 5 FCC Rcd at 6809.

⁸ GTE Comments dated June 19, 1989 in CC Docket No. 87-313 ("D.87-313") at 25.

investment and depreciation decisions.⁹ GTE suggested that "[i]mplementation of price cap regulation should cause a major reassessment and revision of the Commission's methods and procedures with regard to exchange carrier depreciation. This reassessment should lead to increased responsibility for company management."¹⁰

This continues to be GTE's position. GTE believes that Option D is the only option that establishes a firm and logical linkage between Price Cap regulation and depreciation prescription because it is predicated on carrier responsibility for its own capital investment decisions.

Further, the most significant cost savings will result from Option D. The savings will arise from a reduction in costs of conducting depreciation studies. These savings, and others, are a vital component of a carrier's ability to improve efficiencies and compete in the global economy. An industry estimate of the savings has been included in the comments filed in this proceeding by the United States Telephone Association ("USTA"). As a Price Cap carrier, GTE would be able to avoid the costs of collection and analysis of extensive historical data for depreciation study purposes. The main focus could be placed where logic says it belongs: on estimation of the impact of future technologies, competition and business change to establish depreciation recovery periods.

In summary: GTE urges the Commission to adopt Option D for Price Cap carriers. This *Price Cap Carrier Option* – the filing of depreciation rates without supporting data – would simplify depreciation in compliance with the Communications Act. Option D, the only option consistent with Price Cap regulation, will ultimately benefit consumers and shareholders by providing LECs incentives for investment consistent with the competitive market.

⁹ *Id.* at 30.

¹⁰ *Id.* at 29.

4. Under Option D, the Price Caps sharing mechanism will not dictate the depreciation decisions of exchange carriers.

The *Notice* (at 152) seeks comments on whether the Price Caps sharing mechanism will have any impact on the depreciation decisions of exchange carriers. In implementing depreciation under Option D, sound exchange carrier management will not be significantly influenced by the Price Caps sharing mechanism for a number of reasons:

First: Sharing is a feature of the Price Caps plan, which consciously steps away from the traditional rate-of-return, cost-of-service control mechanism. Sharing was included in Price Caps merely as a "backstop" to counter variation in individual exchange carrier productivity versus the average productivity factor established by the Commission.¹¹ It was not designed to reimpose on exchange carriers the burdens of rate of return regulation.

Second: Exchange carrier decisions must be driven by the needs of the network and the demands of customers. For example, recent industry technology and demand forecasts indicate that, to compete successfully in the future, an exchange carrier must deploy a broadband network by 2015 and in some markets by 2010.¹² An exchange carrier must be focused on the deployment of technology to satisfy customers. Departing from carefully developed investment planning for the sake of transitory (and very theoretical¹³) "sharing" benefits would be nonsensical. A company has too much at stake to let sharing concerns distract from its focus on meeting competition.

¹¹ D.87-313 Second Report and Order, 5 FCC Rcd at 6801.

¹² Vanston, Lawrence K., *New Telecom Services and the Public Network*, NEW TELECOM QUARTERLY 1Q93, at 18-22.

¹³ It must be stressed that the sharing mechanism is not a refund mechanism. It may lead to an adjustment in a company's formula, but that does not necessarily produce a change in rates. Indeed, GTE's rates are below the level it is authorized to charge under Price Caps.

Moreover, notwithstanding the operation of the sharing mechanism, exchange carriers must come within the parameters of the Price Caps plan. This imperative again impels the exchange carrier to avoid sacrificing sound planning of investment decisions to transitory benefits in terms of sharing.

Third: In any case, exchange carriers must comply with Generally Accepted Accounting Principles ("GAAP") which are made applicable by Parts 32 and 64 of the Commission's Rules. These principles, which govern the actions of the carriers and protect the interest of customers and investors, are safeguarded by a company's independent financial auditors under the oversight of the Securities and Exchange Commission.

Accordingly: The sharing mechanism will not materially affect exchange carrier depreciation decisions.

5. If the Commission does not adopt Option D, GTE would first recommend Option B, and then Option A.

Assuming the ranges established would be reasonable, GTE finds some merit in Option B, the *Range of Rates Option*. There is somewhat less merit in Option A, the *Basic Factor Range Option*. While these two options are far inferior to Option D, either one would represent a modest improvement over the present practice.¹⁴

GTE discusses *infra* the positive aspects and drawbacks of these Options B and A.

Option B - the *Depreciation Rate Range Option*:

This simplification option permits the Commission to establish a range of depreciation rates for each of the applicable accounts. It differs from the *Basic Factor Range Option* (the establishment of ranges for each of the basic factors) in that it would establish the depreciation rate ranges without use of the formula now employed to

¹⁴ Even this cannot be said for Option C, the *Depreciation Schedule Option*, which would move us in precisely the wrong direction. See discussion *infra*.

develop the depreciation rates. This would make unnecessary the underlying basic factor information.

Compared to present practice, Option B should create additional flexibility and reduce administrative costs. However, a great deal depends on the choice of ranges. It also depends on the source of the ranges. The *Notice* (at 150) proposes that, under Option B, "ranges should be determined from a statistical analysis of currently-prescribed rates." In GTE's view, it would be far better to make the source of the ranges industry-proposed rates. Using currently prescribed rates (with plus or minus one standard deviation) would be tantamount to a self-fulfilling prophesy, in which the current, inadequate ranges dictate future results. Since historically the FCC has tended to prescribe in a fairly narrow range, basing ranges on currently prescribed rates would lead to many companies falling outside the ranges and having to file for numerous exceptions. To the extent this happens, it would make the range concept essentially meaningless. GTE urges the FCC — if it chooses Option B — to base its range prescriptions on industry proposals.

Keeping the goal of simplification in the forefront, in order to establish workable ranges the Commission should use industrywide data obtained from a statistical analysis of the carrier-proposed rates as the initial basis. To these ranges could be applied, as proposed by the *Notice* (at 150), a range of +/- one standard deviation. GTE believes these ranges should be established on an account-by-account basis, as proposed by USTA.

Ranges will most likely have to be updated because of changes in technology, competition, and customer demand. But GTE believes this will only have to be done on a five year cycle. The procedure for updating ranges, however, should be postponed until the Commission and the carriers have had some experience with the application of the range concept.

The *Notice* (at 150) asks whether the FCC "should ... establish two sets of ranges: one for LECs and one for IXC's." GTE suggests that where IXC's and LECs are using the same type of equipment (in some cases identical equipment) – which is the case to a considerable degree – the determination of rate ranges should not be done separately. The two groups have the same customers, carry the same traffic and generally use the same or comparable switching, transport, or other technologies. Now both groups face competition. Justifiable differences in depreciation ranges between the exchange and interexchange markets are rare and disappearing. In GTE's view, the same depreciation rate ranges should apply to all providers.

GTE suggests that, if the Commission decides in favor of the *Range of Rates Option*, depreciation rate ranges should be applied to all accounts, not just to the small and non-infrastructure accounts. If the reform is to be effective it must embrace the larger accounts. Otherwise, it will be no more than a hollow exercise.

Any prescription, however, must allow for flexibility where it can be established that the individual characteristics of a carrier render the range invalid for individual accounts. To the extent a carrier's depreciation rates lie outside these ranges initially, that carrier should have the option of waiting to implement the ranges until the next study cycle. For the sake of an orderly transition and to maintain the balanced schedule already developed by the Commission, GTE's recommendation is Option B should be implemented at the time of a company's three-year review.

The establishment of ranges under Option B leads to limited simplification of the current process. A more extensive simplification will be realized if carriers are allowed to make annual rate changes to their accounts within the established ranges.

Since the Commission will not employ the remaining life formula if it adopts the rate range option, the *Notice* (at 150) has proposed that a true-up mechanism might be required. For Price Cap carriers, a true-up mechanism already exists. If a carrier achieves 100 percent recovery (plus or minus net salvage), the depreciation rate will be

discontinued.¹⁵ If it should happen that an asset survives past the point where there has been full recovery of capital, there is no harm to the ratepayer since the investment and the reserve are equal – which is tantamount to removal from rate base.

Option B is an improvement over the current process. GTE stresses, however, that, for Price Cap carriers, Option D is far better because it is consistent with Price Cap regulation, and will ultimately benefit consumers and shareholders by providing exchange carriers incentives for investment consistent with the competitive market.

Option A - Range for Basic Factors Option:

Under this option, the carriers would be permitted to select, from an established range, their basic factors which includes FNS, projection life, and survivor curve for each applicable account. This simplifies the current process because the detail information to support the carriers selection of certain factors would no longer be required. *Notice* at 148.

GTE draws many of the same "range" conclusions as it did under Option B. Briefly summarized, the ranges should be:

1. Sufficiently wide and established on carrier-proposed factors.
2. Reviewed periodically, e.g., every five years.
3. Determined in the same proceeding for IXCs and exchange carriers.
4. Established for all accounts.
5. Phased in over the next three year study cycle.

The *Notice* (at 150) seeks comment on the continued use of Equal Life Group ("ELG") grouping procedure since it is proposing the use of industrywide data to determine curve shapes for accounts instead of account-specific data for individual

¹⁵ The objective of a depreciation system is to reasonably match asset recovery with consumption. Upon full recovery of investment for an entire asset class (account) prior to consumption of those assets, the company must discontinue the depreciation rate application. Thus, current safeguards prevent recovery of over 100 percent (plus or minus net salvage).

carriers. GTE advocates the continued use of ELG methodology even if industrywide data is used. ELG is a reasonable attempt to measure the consumption of capital of long lived investments.

The drawbacks of Option A are even greater than those of Option B. Again, for Price Caps carriers, there is no longer a need for a detailed process. While Option A would be an improvement over existing processes, adoption of Option D would be far better policy.

In summary: GTE believes that Option B and Option A, in that order, would be the next best alternatives to Option D. This is based on the assumptions that (i) the ranges are both reasonable and applied to all accounts, and (ii) there is a substantial reduction in the administrative information to be filed with the Commission.

6. Option C, the *Depreciation Schedule Option*, is not only the worst of the four proposed options; it would constitute a step backwards.

Option C entails the establishment of a depreciation schedule based on average service life, retirement pattern and salvage value developed by the Commission for each applicable plant account. *Notice* at 151. These schedules would then be applied by the carriers to each investment account by vintage. The Commission believes that this option offers a "greater degree of simplification than range options and the greatest degree of depreciation expense certainty, but it also offers the greatest deviation from accuracy in matching allocation of costs with plant consumption." *Id.*

GTE opposes the use of the *Depreciation Schedule Option* on the grounds that it would be extremely difficult to administer from an accounting perspective. For GTE, it would require a complete reprogramming of its record keeping mechanisms. This is because the current depreciation expense system does not retain plant balances by

vintage.¹⁶ GTE's previous experience with such a system uncovered many hidden complexities that proved it to be impractical.

For Price Cap carriers, certainty of depreciation expense levels should not be a primary consideration in this process. A more crucial objective is the establishment of depreciation levels that adequately measure the consumption of assets and that, more importantly, ensure carriers are able to establish asset recovery rates commensurate with the new, higher levels of risk for the local exchange industry not reflected in historical analysis. At a time when the gravest questions are being raised about the principle of steering a ship by its wake, adoption of Option C would move Commission policy in precisely the wrong direction.

In summary: In GTE's view, Option C, the *Depreciation Schedule Option*, (i) is the most undesirable of the four options; and (ii) would not be a simplification, would not be an improvement over present practice, would be a step in the wrong direction.

7. GTE opposes the removal of the net salvage treatment from the depreciation process.

The current depreciation process and the four simplification options offered by the FCC include net salvage (salvage proceeds minus cost of removal) as a part of the depreciation process. In an attempt to further simplify the entire process of capital recovery, the FCC is considering whether net salvage should be removed from the depreciation process. This would require carriers to record cost of removal and salvage as current period charges and credits. GTE opposes the removal of net salvage from the depreciation process.

Under GAAP, the basic principle of matching revenue and expense is applied to long-lived assets that are not held for sale in the ordinary course of business. The goal of depreciation for long-lived assets is to provide a reasonable, consistent matching of

¹⁶ This system should not be confused with the existing Continued Property Record system.

revenue and expense, by systematically allocating the cost of a depreciable asset over its estimated useful life. The amount subject to depreciation may differ from the asset's original cost (due to salvage value and cost of removal) and is called the asset's depreciable base.

Within the telecommunications industry (especially GTE), there are several classes of plant where the cost of removal (*i.e.*, material and labor charges) is a significant portion of the asset's total value. In this case, to reasonably match revenue and expense, it is necessary to factor in the cost of removal charges within the asset's depreciable base to calculate the appropriate depreciation expense charges.

To exclude this significant cost from the asset's depreciable base and record this cost as incurred could distort the overall financial results. This distortion would be caused because a significant expense would be incurred and recorded with no associated revenue stream – since the asset has been removed from service. Cost of removal is a known, significant cost. In compliance with the GAAP matching principle, it should be allocated to the period where economic benefits are derived. Reinforcing this conclusion is the consequences of the increased competition within the telecommunications industry discussed *supra*, which may mean that portions of the existing infrastructure will be rendered obsolete sooner than anticipated.

Further, if GTE were to exclude removal cost from an asset's depreciable base, these assets would be recorded in the financial records with a larger Net Book Value. This would be in violation of the intent of the conservatism principle, which prefers the understatement (versus overstatement) of net income and net assets where any potential measurement problems exist. If any existing infrastructure is rendered obsolete (because of technological changes and/or competition), GTE would have to incur an even larger write-off on existing assets. Once again, GTE believes that excluding removal costs could significantly distort the financial results and violate the intention of GAAP. GTE recommends continuing to include cost of removal within an

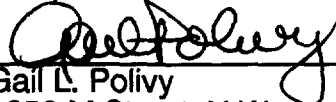
asset's depreciable base, which would allow GTE to properly recover the asset's total cost over its estimated useful life.

In summary: GTE believes that no change should be made to the current net salvage treatment because salvage and cost of removal are appropriately addressed within the depreciation process.

Respectfully submitted,

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Certificate of Service

I, Jennifer R. McCain, hereby certify that a copy of the foregoing "GTE's Comments" has been mailed by first class United States mail, postage prepaid, on the 10th day of March, 1993 to the following party:

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